

Research note

2 September 2009

Power and the Passion: GDP positive, while RBA stays on hold, but more optimistic

- The RBA held the official cash rate unchanged at 3.0% yesterday, as widely expected by markets.
- The Board did, however, signal some improved optimism for the Australian economy, stating “Economic conditions in Australia have been stronger than expected, with consumer spending, exports and business investment notable for their resilience”
- Today’s Q2 09 GDP data showed a positive number, up 0.6%/qtr and 0.6%/yr
- Growth on the quarter was driven by domestic demand through private consumption and private investment.
- One consequence of the better-than-expected economic performance is that the Government’s May estimates for the Budget deficit over 2009/10 and the outyears are likely to be too pessimistic, with smaller deficits now in prospect.
- While the Government is unlikely to update its forecasts until the MYEFO, due October/November, one implication of the better Budget performance is that the volume of Commonwealth bond issuance in 2009/10 and the years ahead will be lower than previously expected.

The RBA: laying the ground work for rate hikes

At the Board meeting yesterday the Reserve Bank of Australia (RBA) decided to leave the cash rate unchanged at 3.0%, as expected. In the note following the decision, however, the RBA did signal a shift in its thinking regarding the outlook for growth, the risks to growth and crucially the path of inflation.

On growth the RBA had said previously “*investment would remain weak*” but this was changed to “*investment spending over the year may not be as weak as earlier expected*”. This followed positive Capital Expenditure data released last week. The RBA also believes that the “*major economies appear to be approaching a turning point*” rather than just the US economy.

On risks to growth the RBA highlighted the “*effects of economic weakness on the balance sheets of financial institutions ...as one of the main remaining risks to the global expansion*”.

On the path of inflation the RBA’s expectations changed from “*moderation (in prices) should continue over the year ahead*” to in this statement “*underlying inflation should continue to moderate in the near term, but the likelihood of inflation being persistently below the target now looks low*”

This view follows the August “Statement on Monetary Policy” and last month’s Parliamentary Testimony where the RBA Governor stated on a number of occasions that the current 3% cash rate was well below ‘normal’ and that the time was approaching for a return to a more normal policy setting.

When pushed to nominate what a ‘normal’ interest rate was in the August Parliamentary testimony, the RBA Governor offered the view that, while the normal rate moves from time to time, it was likely much closer to 5% than the current 3%. The RBA Governor has also stressed a number of times in the recent past that a 3% cash rate is an ‘emergency’ measure and now that the ‘emergency’ has passed it was time to think about unwinding some of this stimulus.

The passing of the ‘emergency’ was confirmed in Australia’s Q2 09 GDP data which showed the Australian economy expanded 0.6% in the quarter and 0.6% annually. But there still remains some uncertainty about the trajectory of the economic recovery with the positive impact from direct payments to consumers and the First Home Owners Grant passing over coming months.

So for the RBA we have a situation where interest rates were cut to 3% to offset some of the effects of an anticipated deep recession. It turns out the recession is pretty mild and the 3% 'emergency' rate is no longer needed. To be sure, the economy still needs some stimulus from monetary policy....just not as much as a 3% cash rate implies.

So what will be the RBA's exit strategy? The market (OIS) is currently pricing in a low chance of a hike in October and a high chance by November and another move by December (7bp by October, 21bp by November and 38bp by December) and then for a rate over 4% by May 2010.

With financial markets now positioned for rate hikes in coming months, the RBA will now look to change household and business expectations to rate rises. With no formal presentations by the RBA over the coming months, this is likely to occur through the media and any further detail contained in the RBA Board Minutes.

First stop for the cash rate is likely to be 4% over H1 2010, and then reassess to see how quickly/slowly they need to move towards 5%. Markets will need to be prepared, therefore, for a change in the environment into 2010 that includes a higher cash rate, higher mortgage and business lending rates and likely upward pressure for the AUD.

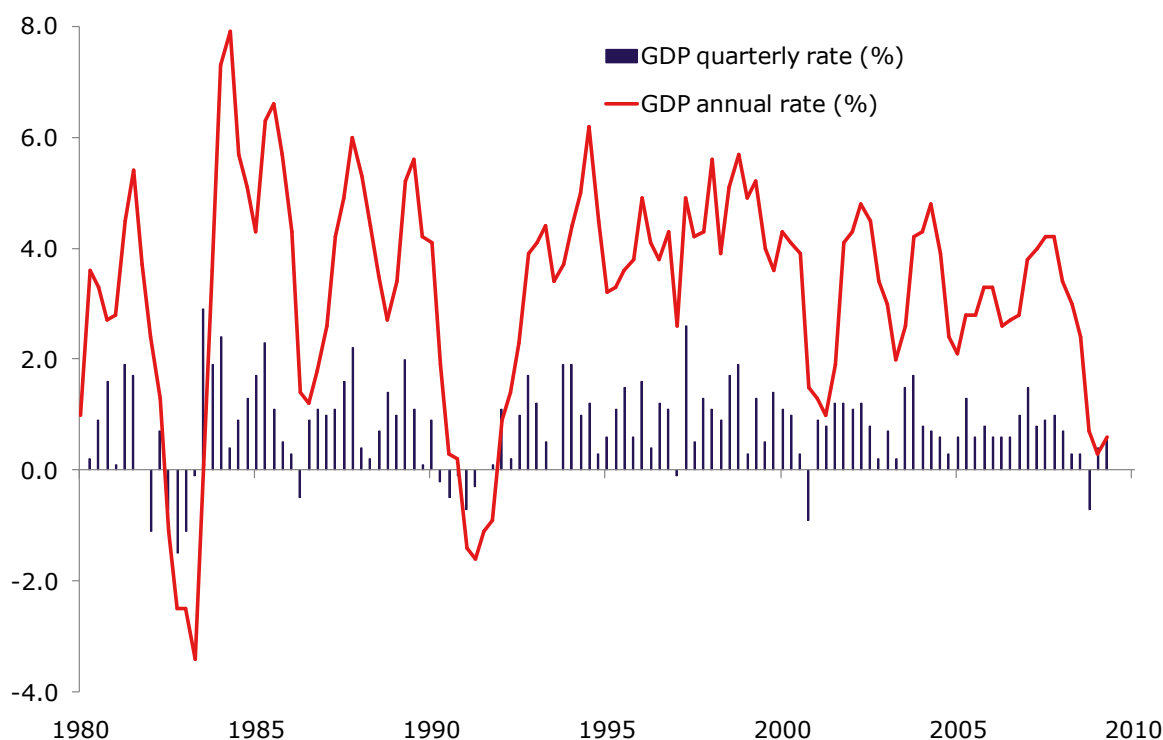
Q2 09 GDP:

Today's Q2 09 GDP reading showed growth of 0.6% for the quarter and 0.6% on a yoy basis. Australia's economy, (as measured by gross domestic product, GDP) grew by 0.6% in the Q2 09, higher than market expectations (0.3%/qtr) and a further increase from 0.4% growth in Q1 09. The annual pace of growth rose to 0.6%/yr, from 0.4%/yr in Q1 09, but well down from 3.0%/yr in Q2 08. See chart below for details.

In Q2 09 the strength in the economy was led by domestic demand; both private consumption up 0.8% and private investment up 0.7%. Though partial indicators had highlighted strength in business investment (driven by tax deductions for small businesses) this result is still a stunning turnaround from the 6.1% fall in Q1 09. The weakness in the economy came from a fall in net exports, driven by faster growth in imports, up 2.1%, than exports, up 1.0% while falling inventories continued to subtract from growth.

Dwelling investment fell by 5.5%/qtr, matching a 5.6% fall in the previous quarter. This is likely to turn positive in the current quarter, in line with strong growth in building approvals. Elsewhere business investment was driven by strong growth in plant and equipment but offset by weak commercial construction. Gross National Expenditure (GNE) rose 1.0%/qtr compared to a revised fall of 0.9%/qtr in Q1 09.

Annual and quarterly change in GDP

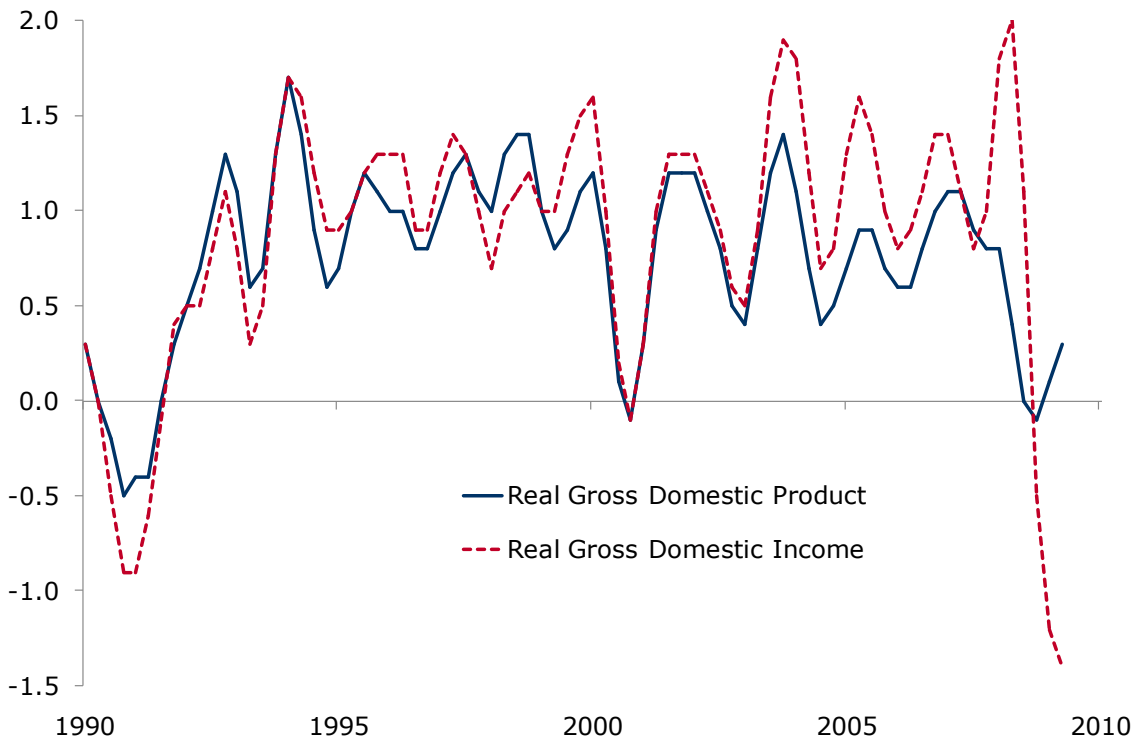


Data to 30 June 2009

As highlighted in our note on March quarter GDP release, it is also important to focus on what is happening on the income side of the economy. Real gross domestic income adjusts the GDP measure for changes in the Terms of Trade (export prices relative to import prices). This disparity continued in the June quarter. Real gross disposable income declined by 1.1%/qtr in the June qtr 2009, with the terms of trade down 6.9%/qtr, following a 5.5%/qtr fall in the March qtr 2009. A fall in company profits also detracted from the income measure of the economy. One surprise is that this fall in income has yet to seriously detract from capital expenditure within the economy, with figures over the quarter showing firm business investment, contrary to expectations.

While the quarterly GDP figures for the production side of the economy are positive, it seems the income side of the economy remains in recession.

Change in quarterly GDP by different measures



Data to 30 June 2009

State by State

Looking at the breakdown of the individual state final demand figures also proves interesting. Victoria recorded a strong 3.0%/qtr for June, reflecting the benefits of minimal interaction with the resources sector. Tasmania (+1.6%), Western Australia (+1.6%), South Australia (+1.3%), NSW (+0.5%) and the ACT (+0.2%) also recorded positive growth. The Northern Territory (-0.4%) and Queensland (-0.1%) recorded a contraction in State Final Demand for the June quarter.

Budget and debt implications:

One of the major implications flowing from the better-than-expected economic outlook is that the 2009/10 Budget deficit is now likely to be smaller than forecast. At the May Budget the Government estimated the deficit for the year at \$A57.6bn, or 4.9% of GDP. This estimate was based on economic growth for the year of -0.5%. Given that it now looks increasingly likely that growth in 2009/10 will be positive (ie. the RBA recently revised their forecast as at June 2010 to +1.0%) then the 2009/10 Budget deficit could be expected to be revised substantially lower when the Government releases its Mid-Year Economic and Fiscal Outlook (MYEFO) in October/November.

A better Budget outlook also implies lower debt issuance needs. At Budget-time the Government estimated a Treasury bond issuance program for the year of \$A60bn, with bond tenders of around \$A700m-\$A1bn per week.

Recently, however, the Australian Office of Financial Management (AOFM) has updated this guidance to include weekly bond tenders of around \$A500m-\$A1bn per week – perhaps already signalling a scaling back of their borrowing needs in anticipation of better Budget news.

Through both the abolition of the 10% interest withholding tax (IWT) on Commonwealth bonds and the stated reintroduction of Inflation-linked bonds, the AOFM is actively exploring ways to help it funds its 2009/10, and beyond, borrowing needs, which will also continue to imply less than previously anticipated issuance into the nominal Treasury bond market.

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